88-1186

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No. 88-

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1988

CONNECTICUT NATIONAL BANK,
Petitioner,

v.

HENRY HERSKOWITZ, *et al.*,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

Whether, in an action alleging that shareholder approval of a leveraged buyout had been obtained by means of a materially misleading proxy statement in violation of Section 14(a) of the Securities Exchange Act of 1934, the Court of Appeals for the Third Circuit erroneously held an independent investment bank, whose sole involvement was to render an opinion to a special committee of outside directors that the proposed transaction was fair from a financial point of view, to the same negligence standard previously applied to an issuer's officers and directors, rather than the *scienter* standard previously applied to outside professional advisors, thereby creating a conflict among the courts of appeals on a matter of great national importance to the financial community and investing public.

Whether the Court of Appeals for the Third Circuit misapplied the law of its own and other circuits concerning the standard for materially misleading statements applicable to opinions and projections in proxy materials when it held that plaintiffs' expert testimony, disputing the reasonableness of the tax rate chosen for use in one of many analyses considered by an investment bank in rendering a fairness opinion, created a jury question, and, therefore, the trial court had erred in removing the issue whether there was a reasonable basis for the bank's utilization of the then-existing federal tax rate from the jury's consideration of whether the bank's fairness opinion was misleading.

LIST OF PARTIES

The parties to the proceeding below were petitioner Connecticut National Bank and its co-petitioners: Nutri/System, Inc., Harold Katz, Martin S. Begun, Thomas W.L. Cameron, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey II and John E. Sylvester; and the following respondents, who are the representative plaintiffs in six consolidated class actions: Henry Herskowitz, Alan Rosman, Joseph Fabian, Nussim Husni, Donald Sunshine, Jack Potok, and Fred Potok.

RULE 28.1 LIST

Pursuant to Rule 28.1 of the Rules of the Supreme Court, petitioner herein makes the following statement disclosing its parents, non-wholly owned subsidiaries and affiliates:

Shawmut National Corporation
Shawmut Bank, N.A.
Shawmut Corporation
Arlington Trust Company
Chester Bank
First Bank
First Bristol County National Bank
Framingham Trust Company
People's Bank, N.A.
The Provident Institution for Savings
Seymour Trust Company
Shawmut Bank of Franklin County
Shawmut Bank of Hampshire County, N.A.
Shawmut Bank of Southeastern Massachusetts, N.A.
Shawmut First Bank and Trust Company
Shawmut Worcester County Bank, N.A.
State Savings Bank
Connecticut National Trust Company of Florida
CNB Discount Brokerage, Inc.
Hartford Trust Company of New York
One Federal Asset Management
Shawmut Brokerage Services, Inc.
Shawmut Credit Corp.
Shawmut Export Corp.
Shawmut Financial Corp.
Shawmut National Capital Corporation
Shawmut National Ventures Corporation
Connecticut National Mortgage Company
Shawmut First Mortgage Corp.
Shawmut Mortgage Corporation

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED FOR REVIEW	i
LIST OF PARTIES	ii
RULE 28.1 LIST	iii
TABLE OF AUTHORITIES	vi
OPINION BELOW	1
JURISDICTION	1
STATUTES INVOLVED	2
STATEMENT OF THE CASE	2
REASONS FOR GRANTING THE WRIT	8
I. THIS COURT'S GUIDANCE IS NECESSARY TO RESOLVE A CONFLICT BETWEEN THE CIRCUITS ON THE STANDARD OF LIABILITY FOR MATERIAL MISSTATEMENTS IN PROXY MATERIALS BY PROFESSIONAL OUTSIDE ADVISORS UNDER SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AN ISSUE OF VITAL IMPORTANCE TO THE NATION'S FINANCIAL COMMUNITY AND INVESTING PUBLIC	8
A. The Third Circuit Has Improperly Judged an Outside Financial Consultant's Liability by a Negligence Standard Rather Than the *Scienter* Standard Previously Adopted by the Sixth Circuit	9
B. The Third Circuit's Decision Imposing a Negligence Standard on Outside Advisors Will Have Enormous Adverse Ramifications for the Financial Community and Investing Public	12

TABLE OF CONTENTS – *(Continued)*

Page

C. *Scienter* Is the Appropriate Standard for Determining the Liability of Outside Professional Advisors Because It More Accurately Reflects Their Relationship to Transactions Requiring Proxy Statements 14

II. THIS COURT SHOULD GRANT CERTIORARI BECAUSE THE THIRD CIRCUIT'S APPLICATION OF THE TEST FOR MISLEADING OPINIONS IS CONTRARY TO ITS OWN AND OTHER COURTS' WELL-ESTABLISHED PRECEDENTS AND CREATES DOUBT ABOUT THE APPROPRIATE STANDARD ... 15

CONCLUSION..... 19

APPENDIX

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT (857 F.2d 179)..... A-1

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DENYING CNB'S PETITION FOR REHEARING..... A-27

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DENYING NUTRI/SYSTEM, INC., *ET AL.*'S PETITION FOR REHEARING..... A-28

JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA..... A-29

TEXT OF SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 14a-9 ..... A-30

FAIRNESS OPINION OF CONNECTICUT NATIONAL BANK A-32

TABLE OF AUTHORITIES

CASES: Page

Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980)..... 7,8,9-10,11,12,15

Anderson v. Liberty Lobby, Inc., 477 U.S. 242 (1986) 18

Eisenberg v. Gagnon, 766 F.2d 770 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985)..... 16,17

First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978) 17

Fradkin v. Ernst, 571 F. Supp. 829 (N.D. Oh. 1983) 11,15

Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) 11

Gottreich v. San Francisco Investment Corp., 552 F.2d 866 (9th Cir. 1977)..... 16

Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976)..... 7,8,10,11,12

Herskowitz v. Nutri/System, Inc., 857 F.2d 179 (3d Cir. 1988)..... *passim*

Isquith v. Middle South Utilities, 847 F.2d 186 (5th Cir.), *cert. denied*, 109 S. Ct. 310 (1988) 16

Marx v. Computer Sciences Corporation, 507 F.2d 485 (9th Cir. 1974)..... 16-17

SEC v. Okin, 137 F.2d 862 (2d Cir. 1943)..... 16

Zatkin v. Primuth, 551 F. Supp. 39 (S.D. Cal. 1982) 12

STATUTES AND OTHER AUTHORITIES:

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) 2

TABLE OF AUTHORITIES – *(Continued)*

STATUTES AND OTHER AUTHORITIES: Page

Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(a) ..... *passim*

Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa 2

28 U.S.C. §1254(1) 2

28 U.S.C. §1331 2

Rule 14a-9, 17 C.F.R. §240.14a-9 2,7,11

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner Connecticut National Bank respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in *Herskowitz v. Nutri/System, Inc.*, on September 13, 1988.

OPINION BELOW

The opinion of the United States Court of Appeals for the Third Circuit is reported at 857 F.2d 179 (3d Cir. 1988), and appears at A-1 of the appendix to this petition ("App.").

JURISDICTION

The Third Circuit filed its opinion and accompanying judgment on September 16, 1988, and denied a timely petition for rehearing and rehearing en banc on October 11, 1988. (App. A-27). This petition is filed

within ninety days of the denial of rehearing. Jurisdiction in this Court is based on 28 U.S.C. §1254(1).

STATUTES INVOLVED

Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(a), and Rule 14a-9, 17 C.F.R. §240.14a-9, promulgated thereunder, are set forth at A-30 to A-31 of the appendix to this petition.

STATEMENT OF THE CASE

On August 6, 1986, the shareholders of Nutri/System, Inc., a nationwide chain of franchised weight-loss centers, voted overwhelmingly in favor of a proposed leveraged buy-out by four of the company's officers. These consolidated class actions by minority shareholders allege that the proxy statement mailed to shareholders a month before the shareholders' meeting contained material misstatements and omissions in violation of Sections 10(b) and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b) and 78n(a).[1]

The role of petitioner Connecticut National Bank (hereinafter "CNB") in the leveraged buyout transaction was limited. Retained in January, 1986, by a special committee of Nutri/System's outside, non-management directors who were not purchasers in the leveraged buyout, CNB was to render an opinion concerning the fairness from a financial point of view of an offer by senior management to purchase the company's common

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1. The complaints, which were eventually consolidated, alleged, *inter alia,* fraudulent omissions in the pre-merger announcement in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and inadequacy of the consideration offered. The district court had subject matter jurisdiction of the case pursuant to Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa, and 28 U.S.C. §1331.

stock. (570a-571a, 955a-958a).[2] CNB did not put the transaction together, nor did it provide any financing or underwriting services. CNB was not rendering advice to management; rather its engagement was to determine whether the price of $7.16 per share of common stock was fair to the minority shareholders, who where being offered the same terms as the majority shareholder, petitioner Harold Katz. (571a, 574a, 2169a-2171a, 343a-344a). For its independent financial analysis, CNB was paid a fee of $75,000, which was not contingent upon the transaction closing. (606a).

After performing an extensive analysis, CNB rendered a preliminary opinion on February 4, 1986, at a Board of Directors' meeting, that the proposed merger consideration was fair. (574a). On July 11, 1986, CNB rendered a final fairness opinion, which was published in the proxy statement issued by Nutri/System's management to obtain the shareholders' approval of the proposed merger. (575a-576a). That opinion, which appears in the appendix to this petition at A-32 to A-38, sets forth CNB's conclusion, based on CNB's analysis and general knowledge and experience in the valuation of securities, that the consideration per share of $6.13 in cash and a subordinated discount debenture in the face amount of $1.03 was fair from a financial point of view as of July 11, 1986, the date of the opinion. (App. A-38). The opinion also summarizes the procedures CNB used in arriving at its conclusion of fairness, including the documents and information examined, the persons interviewed, the facilities visited, the factors considered, and the assumptions and limitations of the opinion.

As described in its opinion, CNB analyzed the proposed price in relation to a myriad of factors, including shareholders' equity, the premium being paid over

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2. Citations followed by a lowercase 'a' are to the joint appendix filed in the Third Circuit; citations preceded by an uppercase 'A' are to the appendix to this petition.

the market price, the trading price per share on the market over the previous year and the sales prices and resulting acquisition measures (such as price to earnings multiples) of other companies in the previous year. (1066a-1073a). CNB also calculated Nutri/System's excess cash as a component of the company's value. Additionally, CNB performed a discounted cash flow analysis. (565a). This procedure projected the possible future performance of the company in terms of the cash to be generated and reduced that projected amount to present value by means of a discount rate that compensated for the risk associated with achieving the projections. (1057a, 1059a). In performing its discounted cash flow analysis, CNB had to project the rate at which Nutri/System would be taxed indefinitely into the future. (998a-999a). CNB utilized a 46 percent tax rate, which was the federal statutory rate in effect at the time both the preliminary and the final fairness opinions were prepared. (996a). This projected tax rate is the only aspect of CNB's fairness opinion that is at issue following the Third Circuit's opinion.

CNB chose the 46 percent rate for many reasons. Although CNB was aware of the ongoing Congressional debate over the proposed Tax Reform Bill of 1986, it concluded that it could not rely on that debate to project another tax rate as the components of taxable income were also slated to change. While there were reports that a tax reform bill would lower the corporate tax rate, the proposed revenue-neutral tax law, which was being extensively revised and amended, was simultaneously being touted as one that would reduce individual taxes by increasing taxes paid by corporations. Furthermore, because CNB's cash flow analysis involved a projection period that went on forever, CNB had to account for the persistent uncertainty concerning the duration of any proposed lower rate in light of the large federal deficits. Against this background of confusion and uncertainty, CNB chose a 46 percent rate, which coincided with the

then-effective federal statutory rate, for its projections of the total tax Nutri/System could be expected to pay — that is, state and local taxes as well as federal taxes. (996a-999a). Moreover, it chose this rate with the knowledge that Nutri/System had historically paid taxes well in excess of the federal statutory rate. (997a, 2222a).

The only evidence offered by plaintiffs to prove CNB's projection of a 46 percent tax rate rendered the fairness opinion materially false and misleading was expert testimony that a different, lower tax rate should have been utilized in performing the discounted cash flow analysis. (678a). While plaintiffs' expert agreed that a discounted cash flow analysis was an appropriate factor to be considered in determining the fairness of the transaction from a financial point of view and also agreed with CNB's projection of a 46 percent tax rate in its earlier February 4, 1986, preliminary opinion (731a, 736a-737a), he opined that CNB should have used a 34 percent tax rate in its final July 11, 1986 opinion. (678a). This opinion of plaintiffs' expert was based solely on articles in the financial press immediately preceding the final fairness opinion that predicted a compromise between the different bills, with different rates, which had passed the House and Senate. (739a-740a). As plaintiffs' expert acknowledged, the 1986 Tax Reform Act did not become law until October 22, 1986, and as of July 11, 1986, the date of CNB's final fairness opinion, the bill had not as yet even been reported out of the House and Senate conference committee. (737a-738a).

The district court sent to the jury, in the form of a special interrogatory, the issue whether CNB's fairness opinion rendered the proxy materials false and misleading. (132a). The jury answered "no," and returned a verdict in favor of CNB as well as the other defendants. (1493a-1495a). While other aspects of the fairness opinion, such as the discount rate used and the excess cash calculated, were subjected to the jury's scrutiny, the

trial court refused to permit plaintiffs to argue to the jury that CNB's utilization of a 46 percent tax rate in its discounted cash flow analysis was an "improper ground" for the fairness opinion. (1235a). At the close of the evidence, the trial court directed a verdict on the 46 percent tax rate issue on two grounds. First, the court found plaintiffs had presented insufficient evidence that CNB either did not believe in its projection of a 46 percent rate or had no proper foundation or rational basis for it, so that no jury could find the fairness opinion false and misleading on the ground that CNB utilized a 46 percent tax rate in its analysis. (1207a-1209a, 1233a-1235a). Second, the proxy statement itself disclosed both the tax rate utilized in projections and the potential for changes in the tax rate as a result of pending tax reform proposals. (1233a-1235a).

On plaintiffs' appeal, the majority of the Third Circuit panel reversed the directed verdict on the 46 percent tax rate issue. Solely on the basis of plaintiffs' expert's opinion, the appellate court found sufficient evidence "to present a jury question as to whether it was reasonable for Connecticut National Bank to render a fairness opinion in July of 1986 based on a cash flow projection that assumed a 46% tax rate for the next five years." 857 F.2d at 185 (App. A-13 to A-14).[3] Circuit Judge James Hunter III dissented, finding the majority had applied the wrong standard for judging an investment banker's projections: "The question before us is not whether the 46% rate was the only one that CNB reasonably could have chosen, but whether there was a reasonable basis for its choice." 857 F.2d at 190 (App. A-25). Judge Hunter found CNB had a reasonable basis as a matter of law for utilizing the 46 percent rate in its

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3. The court of appeals was mistaken about the duration of time over which the cash flow and tax rate projection was made. The trial testimony established that the projection period goes on forever. (998a-999a).

projection because it was the statutory rate in effect at the time the fairness opinion was rendered. Moreover, CNB expressed a reasonable basis for rejecting a lower rate. *Id.*

Because of the remand for re-trial on the 46 percent tax rate issue, the Third Circuit also considered the standard of care to which investment banks rendering fairness opinions published in proxy statements should be held under Section 14(a) of the Securities Exchange Act of 1934. Relying on *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980), CNB argued to the trial court that an investment bank should not be held to a negligence standard for alleged misstatements and omissions in a fairness opinion in violation of Section 14(a). The trial court refused to instruct the jury that, to establish the liability of CNB pursuant to Section 14(a) and Rule 14a-9, plaintiffs had to prove CNB had rendered a materially false and misleading fairness opinion with *scienter*. 857 F.2d at 189 (App. A-23). Instead, the trial court instructed the jury that CNB was to be judged under Section 14(a) by a negligence standard, extending to outside advisors the standard articulated by the Third Circuit for non-management directors in *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976). (1458a). CNB, therefore, filed a protective cross-appeal so that should the Third Circuit overturn the defense verdict, as it eventually did, the trial court would have the benefit of an appellate decision in any subsequent re-trial.

On CNB's cross-appeal, the appellate court refused to follow the Sixth Circuit's interpretation applying differing standards for different actors, depending on their relationship to the transaction, the corporation and its shareholders:

> In asking us to depart from the *Gould* standard for outside advisers such as accountants and investment bankers, Connecticut National Bank relies on *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980), which applied a *scienter* standard for an accountant who prepared a financial statement attached to a proxy statement. The reasoning of *Adams*, however, appears to be inconsistent with that of *Gould*, for it suggests that the *scienter* standard would apply in a section 14(a) case even for officers and directors. This panel is bound by *Gould*, which rejects the application of a *scienter* standard to such persons.

857 F.2d at 190 (App. A-24). Thus, a conflict now exists between the Sixth and Third Circuits, resulting in confusion on the issue of the standard of liability under Section 14(a) to apply to the outside, professional advisor or valuation expert whose opinion or advice is published in a proxy statement.

REASONS FOR GRANTING THE WRIT

I. THIS COURT'S GUIDANCE IS NECESSARY TO RESOLVE A CONFLICT BETWEEN THE CIRCUITS ON THE STANDARD OF LIABILITY FOR MATERIAL MISSTATEMENTS IN PROXY MATERIALS BY PROFESSIONAL OUTSIDE ADVISORS UNDER SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AN ISSUE OF VITAL IMPORTANCE TO THE NATION'S FINANCIAL COMMUNITY AND INVESTING PUBLIC.

The Third Circuit's opinion subjecting outside, professional advisors to a negligence standard for material misstatements in proxy materials pursuant to Section 14(a) of the Securities Exchange Act of 1934, the same standard of liability applied to corporate issuers who

directly benefit from the proposed transaction, has created an irreconcilable conflict between the law of the Sixth and Third Circuits, and will have an enormous adverse impact on the financial community. This Court's guidance is needed to resolve the conflict and to impose the correct standard, a *scienter* standard, which best reflects the relationship of the outside, professional advisor to the transaction, the corporation and its shareholders, and a standard which will best recognize the needs of the financial community and the investing public.

A. The Third Circuit Has Improperly Judged an Outside Financial Consultant's Liability by a Negligence Standard Rather Than the *Scienter* Standard Previously Adopted by the Sixth Circuit.

Until the Third Circuit's decision below, the only federal appellate court to have addressed the standard of liability under Section 14(a) for material misstatements in proxy materials prepared by outside, professional advisors was the Sixth Circuit. In *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980), the Sixth Circuit held that an outside accountant who prepared financial statements to be appended to a proxy statement could only be found liable for material misstatements in the proxy statement on a showing of *scienter*. *Id.* at 428. The accountant had mistakenly indicated that certain restrictions on the payment of dividends applied only to common stock, when, in fact, they applied to capital stock of all classes. *Id.* at 426. The court distinguished the accountant from the corporate issuer of the proxy statement on the basis that the outside accountant, unlike the corporate issuer, "does not directly benefit from the proxy vote and is not in privity with the stockholder." *Id.* at 428. To hold an outside financial consultant to a negligence standard, the court found, would be unreasonably harsh:

> Unlike the corporate issuer, the preparation of financial statements to be appended to proxies and other reports is the daily fare of accountants, and the accountant's potential liability for relatively minor mistakes would be enormous under a negligence standard.

Id.

The Sixth Circuit specifically limited its imposition of a *scienter* standard of liability under Section 14(a) to outside accountants, and made clear that it expressed no view on what standard it would apply to determine liability of the corporate issuer.

> Although we are not called on in this case to decide the standard of liability of the corporate issuer of proxy material, we are influenced by the fact that the accountant here, unlike the corporate issuer, does not directly benefit from the proxy vote and is not in privity with the stockholder.

Id.[4]

Prior to the decision below, the Third Circuit had addressed the issue of the standard of liability under Section 14(a) only in the context of the corporate issuer of a proxy statement. In *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976), the Third Circuit ruled very narrowly that a negligence standard applied under Section 14(a) to outside, non-management corporate directors. As petitioner argued to the Third Circuit, *Gould* and *Adams* can be reconciled by applying a negligence standard to corporate insiders who issue proxy materials and a *scienter* standard to

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4. The Third Circuit plainly misinterpreted the *Adams* opinion when it stated that *Adams* suggested that a *scienter* standard would apply in a Section 14(a) case for officers and directors, as well as outside accountants. 857 F.2d at 190 (App. A-24). The foregoing quotation from *Adams* illustrates that the Third Circuit's interpretation is without basis.

outside, professional advisors, such as investment banks, accountants or valuation experts, whose contributions are simply published in proxy statements.

Indeed, this distinction was clearly drawn by a district court in the Sixth Circuit in *Fradkin v. Ernst*, 571 F. Supp. 829 (N.D. Oh. 1983). In reconciling its appellate court's decision in *Adams* with the Second Circuit's decision in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973), which, like *Gould*, held the corporate issuer of a proxy statement to a negligence standard of liability under Section 14(a),[5] the Ohio court directly addressed the issue

> whether the Court should distinguish between the scienter requirement imposed in the context of corporate issuers and outside accountants under Rule 14a-9 or whether the Court should extend the scienter requirement for outside accountants developed in *Adams* to a case involving a corporate issuer.

571 F. Supp. at 843. The *Fradkin* court concluded that a distinction between the liability of corporate issuers and outside accountants is appropriate, because of the benefit the corporate insider receives from the proxy vote, as contrasted with the outside accountant, who receives no direct benefit. *Id.* at 843.

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5. Although the Second Circuit in *Gerstle* held the corporate issuer of proxy materials to a negligence standard of liability, Chief Judge Friendly's opinion states there were circumstances where *scienter* may be the appropriate standard: "Although this does not mean that scienter should never be required in an action under Rule 14a-9, a number of considerations persuade us that it would be inappropriate to require plaintiffs to prove it in the circumstances of this case." 478 F.2d at 1300. The circumstances which persuaded the court to apply a negligence standard included the value of reinforcing "the high duty of care owed by a controlling corporation to minority shareholders in the preparation of a proxy statement" and the fact that "the transaction redounded directly to the benefit of the defendant," *id.*, precisely the factors absent in CNB's relationship to the Nutri/System transaction.

A district court in the Ninth Circuit has also adopted a *scienter* standard under Section 14(a) for outside accountants and financial advisors. In *Zatkin v. Primuth*, 551 F. Supp. 39 (S.D. Cal. 1982), Coopers & Lybrand, which acted as independent auditor for a corporation involved in a merger, was sued along with the corporation's directors, officers and financial advisor, in a complaint alleging securities fraud under the Securities Act of 1933 and the Securities Exchange Act of 1934, including Section 14. The suit alleged that defendants concealed adverse information about the company's business condition in connection with a proxy statement, registration statement and prospectus to maintain an artificially high price for the securities. Coopers & Lybrand moved to dismiss the Section 14 claims because plaintiff based his claims on allegations of negligence, rather than *scienter*. Quoting at length from the Sixth Circuit's opinion, the *Zatkin* court concurred with *Adams'* reasons for adopting a *scienter* standard for outside accountants and dismissed the Section 14 claims. 551 F. Supp. at 45.

The Third Circuit, on the other hand, erroneously found *Gould* and *Adams* inconsistent and rejected a *scienter* standard for Section 14(a) liability for outside advisors, as well as corporate issuers. 857 F.2d at 190 (App. A-24). Thus, a clear conflict having been created between the law of the Sixth and Third Circuits on the question of the standard of liability under Section 14(a) for outside, professional advisors, this Court should grant certiorari to resolve the conflict.

B. The Third Circuit's Decision Imposing a Negligence Standard on Outside Advisors Will Have Enormous Adverse Ramifications for the Financial Community and Investing Public.

This Court's guidance on the standard of liability for outside advisors under Section 14(a) is crucial because

the current, unsettled state of the law forces outside professional advisors to assume they are subject to the higher, negligence standard of liability. Investment banks, exposed to enormous potential Section 14(a) liability under the Third Circuit's negligence standard, either will be forced out of the business of rendering fairness opinions or will be compelled to charge astronomically higher fees for rendering such opinions in order to offset the risk of being found to have made an innocent mistake in their opinions. Transactions too small to support the premium for the enormous risk created by the Third Circuit's decision will proceed without the benefit of an investment bank's unbiased, disinterested analysis of the fairness of the proposed merger consideration. Perhaps many smaller transactions, unable to bear the higher price for fairness opinions, will simply be abandoned.

The Nutri/System leveraged buyout is precisely the type of transaction that would likely go forward without the benefit of an investment bank's independent analysis of the fairness of the purchase price. CNB's modest fee of $75,000 would certainly be insufficient to offset the risk of liability for mere mistakes in its fairness analysis in this 70 million dollar transaction involving almost 10 million shares of stock. If left uncorrected, the Third Circuit's decision will have far-reaching consequences both for the professional advisors and valuation experts whose work finds its way into proxy statements and for the corporations and shareholders which require their advice.

C. *Scienter* Is the Appropriate Standard for Determining the Liability of Outside Professional Advisors Because It More Accurately Reflects Their Relationship to Transactions Requiring Proxy Statements.

Holding outside professional advisors to the same standard of liability as corporate issuers of proxy statements under Section 14(a) is inappropriate and unwarranted in light of the differences in their relationship to the transaction, the corporation and its shareholders. By granting certiorari, this Court can establish that professional advisors, such as accountants and investment bankers, who render opinions and analyses that corporate insiders choose to publish in proxy materials, will be liable for misstatements only on a showing that the misstatement was made knowingly, intentionally or recklessly.

The Court of Appeals apparently misapprehended the role in the merger transaction of the investment bank retained by outside directors on behalf of minority shareholders and that advisor's relationship to management. The relationship to management is almost adversarial, rather than one of assistance, in light of the conflict inherent in management's dual role as potential purchasers and officers and directors of the corporation. Contrary to the Third Circuit's characterization of CNB's role as "assisting" management, 857 F.2d at 190 (App. A-24), the investment bank retained by outside directors provides an independent review of the transaction, not assistance to management. Proxy statements in such transactions disclose that, as here, the investment bank makes no recommendation to shareholders concerning their vote on the proposed transaction and is to be paid regardless of the outcome of the shareholders' vote. (1948a). It is precisely these differences between the outside advisor and the corporate issuer of proxy materials in terms of their relationship to the shareholders, nexus to the transaction, duration of involvement, and

benefit from the transaction, which led the Sixth Circuit in *Adams* and the district court in *Fradkin* to delineate a *scienter* standard of liability for the outside advisor and a negligence standard for the corporate issuer. The Third Circuit's misunderstanding of that relationship caused it to reach the wrong result.

A *scienter* standard, which would hold the outside advisor liable only for opinions and advice which are intentionally or knowingly false and misleading, would permit the advisor to proceed in the face of a predictable risk and would adequately protect the investor from the unscrupulous advisor. This Court should grant certiorari to establish the appropriate standard of liability under Section 14(a) of the Securities Exchange Act of 1934 and resolve the conflict in the circuits.

II. THIS COURT SHOULD GRANT CERTIORARI BECAUSE THE THIRD CIRCUIT'S APPLICATION OF THE TEST FOR MISLEADING OPINIONS IS CONTRARY TO ITS OWN AND OTHER COURTS' WELL-ESTABLISHED PRECEDENTS AND CREATES DOUBT ABOUT THE APPROPRIATE STANDARD.

The Third Circuit remanded this case for re-trial because it found the trial court had improvidently removed from the jury's consideration of the misleading nature of the fairness opinion one assumption utilized in only one of the many analyses undertaken by the bank in rendering its opinion. In its decision to remand, the majority panel misapplied the Third Circuit's standard for judging the falsity of opinions and projections, a standard well-established in the circuit courts, thereby creating doubt about the appropriate standard. This Court should grant certiorari to annunciate clearly the standard for misstatements of opinions and projections made in connection with securities transactions and to clarify how that standard is to be applied.

The standard for judging false opinions, projections and forecasts was established clearly by the Third Circuit before the panel's decision below. In *Eisenberg v. Gagnon,* 766 F.2d 770 (3d Cir.), *cert. denied,* 474 U.S. 946 (1985), the court articulated the following test for judging whether an opinion or projection is untrue: "An opinion or projection, like any other representation, will be untrue if it has no valid basis, but 'a reasoned and justified statement of opinion, one with a sound factual or historical basis, is not actionable.' " *Id.* at 776, *quoting Marx v. Computer Sciences Corporation,* 507 F.2d 485 (9th Cir. 1974). The court explained further that "an opinion that has been issued without a genuine belief or reasonable basis is an 'untrue' statement." *Eisenberg,* 766 F.2d at 776.

Courts from other circuits have articulated standards for judging false opinions or projections consistent with that set forth in *Eisenberg. See Isquith v. Middle South Utilities,* 847 F.2d 186, 203-4 (5th Cir.), *cert. denied,* 109 S. Ct. 310 (1988) (whether a prediction was false when made "does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction—with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith or had a sound factual or historical basis"); *Gottreich v. San Francisco Investment Corp.,* 552 F.2d 866, 867 (9th Cir. 1977) (financial expert's predictions made with "no basis for claiming such expertise or knowledge" may constitute misstatements of material facts); *SEC v. Okin,* 137 F.2d 862, 864 (2d Cir. 1943) (opinion that operation of subsidiaries caused losses was actionable where defendant admitted there was "no ground" for it); *Marx v. Computer Sciences Corporation, supra,* 507 F.2d at 489-90 (earnings forecast would be "untrue" if opiner "did not then believe earnings would be in that amount or knew that there was reason to believe they would not

be;" forecast "implies a reasonable method of preparation and a valid basis"). *But cf. First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978) (opinion "actionable if there is a gross disparity between prediction and fact").

Under the *Eisenberg* test and those articulated in other circuits, a projection or opinion is not false or misleading because someone disagrees with it, but only if the opiner either did not believe it had or had no rational basis for it. Nevertheless, rather than analyze the evidence concerning CNB's basis for projecting a 46 percent tax rate, the majority below focused solely upon the reasonableness of CNB's conclusion or result, namely the selection of a 46 percent tax rate. The panel incorrectly framed the issue as follows: "whether it was reasonable for Connecticut National Bank to render a fairness opinion in July of 1986 based on a cash flow projection which assumed a 46% tax rate . . . ." 857 F.2d at 185 (App. A-13 to A-14). In other words, the appellate court examined the issue whether the selection of 46 percent was reasonable, instead of whether CNB had a rational basis for its projection of a 46 percent tax rate. Thus, all plaintiffs need to do to create a jury question, according to the Third Circuit majority's articulation of the standard, is introduce testimony that a different expert would have reached a different conclusion on the same set of facts. Under the new standard articulated below, plaintiffs need not, and indeed here did not, present any evidence to show the opiner either did not believe in his opinion or had no rational basis for it.

By contrast, Judge Hunter, in his dissenting opinion below, properly found that CNB had a reasonable basis as a matter of law for its projection of a 46 percent tax rate. He recognized the majority's misapplication of the *Eisenberg* standard: "The question before us is not whether the 46% rate was the only one that CNB

reasonably could have chosen, but whether there was a reasonable basis for its choice." 857 F.2d at 190 (App. A-25).

As a result of its misapplication of the standard for judging allegedly false opinions or projections, the majority panel below incorrectly found a jury question where none, in fact, existed. In its recent opinions, this Court has expressed its policy of encouraging trial courts to dispose of cases, where appropriate, at the summary judgment or directed verdict stages. This Court recently admonished, "the trial judge must direct a verdict if, under the governing law, there can be but one reasonable conclusion as to the verdict." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 106 S. Ct. 2505, 2511 (1986). The Third Circuit's reversal of the trial court's directed verdict flies directly in the face of this Court's express policy of encouraging the use of that mechanism to dispose of issues where appropriate. Because the appellate court applied the wrong standard for judging misstatements in opinions or projections, it found a question of fact immaterial to the outcome of the suit and unnecessarily ordered a re-trial.

This Court should grant certiorari to correct the misapplication of settled precedent below and to ensure uniformity and clarity among the circuits on the standard for judging the falsity of opinions or projections issued in connection with securities transactions, an issue of great significance in this nation's securities laws.

CONCLUSION

The Third Circuit's opinion creates a split of authorities between the Third and Sixth Circuits on the standard of liability for outside professional advisors under Section 14(a) of the Securities Exchange Act of 1934. In addition, it represents a troubling departure from established precedent for judging the falsity of opinions or projections issued in connection with securities transactions. Only this Court can resolve the conflict and articulate the definitive standard.

Accordingly, Connecticut National Bank respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit reversing the district court's directed verdict and affirming the trial court's ruling on the standard of liability under Section 14(a).

Respectfully submitted,

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DATED: January 9, 1989

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Opinion of the United States Court of Appeals for the Third Circuit

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 87-1786, 87-1787, 87-1788,
87-1789, 87-1790, 87-1791
Nos. 87-1798, 87-1799, 87-1800,
87-1801, 87-1802, 87-1803

HENRY HERSKOWITZ, on behalf of himself
and all other similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK,
JOHN E. SYLVESTER, THOMAS W.L. CAMERON

Henry Herskowitz, Appellant No. 87-1786
Connecticut National Bank,
Cross-Appellant No. 87-1798

ALAN ROSMAN, on behalf of himself
and all others similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK,
JOHN E. SYLVESTER, THOMAS W.L. CAMERON

Alan Rosman, Appellant No. 87-1787
Connecticut National Bank,
Cross-Appellant No. 87-1799

JOSEPH FABIAN, on behalf of himself
and all others similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK,
JOHN E. SYLVESTER, THOMAS W.L. CAMERON

Joseph Fabian, Appellant No. 87-1788
Connecticut National Bank,
Cross-Appellant No. 87-1800

NISSIM HUSNI, on behalf of himself
and all others similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK,
JOHN E. SYLVESTER, THOMAS W.L. CAMERON

Nissim Husni, Appellant No. 87-1789
Connecticut National Bank,
Cross-Appellant No. 87-1801

DONALD SUNSHINE, on behalf of himself
and all others similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK, JOHN E.
SYLVESTER,
THOMAS W.L. CAMERON

Donald Sunshine, Appellant No. 87-1790
Connecticut National Bank,
Cross-Appellant No. 87-1802

JACK POTOK, FRED POTOK, JOINT TENANTS,
on behalf of themselves and all others
similarly situated

vs.

NUTRI/SYSTEM, INC., HAROLD KATZ,
A. DONALD McCULLOCH, JR., ALBERT J. DI MARCO,
REEF C. IVEY, II, DUANE E. JARVIS,
NORMAN AMSTER, MARTIN S. BEGUN,
MERRILL LYNCH CAPITAL MARKETS, INC.,
CONNECTICUT NATIONAL BANK,
JOHN E. SYLVESTER, THOMAS W.L. CAMERON

Jack Potok and Fred Potok, Appellants No. 87-1791
Connecticut National Bank,
Cross-Appellant No. 87-1803

On Appeal from the United States
District Court For the
Eastern District of Pennsylvania
D.C. Civil Nos. 86-0711, 86-0712,
86-0725, 86-0800, 86-0828, 86-0877

Argued June 21, 1988

Before: GIBBONS, Chief Judge, and
HIGGINBOTHAM and HUNTER, Circuit Judges

(Opinion Filed: September 13, 1988)

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OPINION OF THE COURT

GIBBONS, C.J.

Shareholders of Nutri/System, Inc., who are plaintiffs in six consolidated class actions challenging

the terms of a leveraged buyout, appeal from a judgment in favor of the defendants. The defendants include the Corporation, its senior management which purchased Nutri/System's business, its board of directors, and Connecticut National Bank, which issued an opinion letter on the fairness of the transaction. The shareholders challenged the leveraged buyout on the ground that its approval by shareholders was procured by use of a materially false and misleading proxy statement in violation of sections 10(1) and 14(a) of the Securities Exchange Act of 1939. 15 U.S.C. §§ 78(j)(b) and 78(n)(a). They also alleged that the buyout was at an unfair price in violation of Pennsylvania law which reached fiduciary duties owed by its officer and directors to Nutri/System's public shareholders. Connecticut National Bank has filed a protective cross appeal contesting the standard of care on which the plaintiffs' claim against it was submitted to the jury. We conclude that two trial errors require a new trial. Since we will remand for a new trial it is appropriate to address and reject other claimed errors.

I

Nutri/System, founded in 1972 by Harold Katz, operates and franchises weight-loss centers. From a single weight-loss center in Philadelphia, Nutri/System had grown by 1983 to a nationwide chain of 70 centers producing annual revenues of $133 million. In that year a secondary public stock offering was made by Katz, who retained a majority interest. Soon thereafter the company experienced a decline in its fortunes, including litigation with some of its franchisees. A settlement of this litigation reduced Nutri/System profits on sales of food products to franchisees, and competition in the industry put pressure on revenues. Katz decided to sell his share of the company in 1984. A proposed sale of the whole company to an acquisition

group at approximately $9.00 a share ($90 million) fell through early in 1985, when the acquisition group was unable to obtain adequate financing. By the spring of 1985 the management was demoralized, and Nutri/System stock was trading at less than $4.00 a share.

In March, 1985 Katz hired A. Donald McCulloch, Jr. as president of Nutri/System. Mcculloch had a strong record in revitalizing other foundering companies, and he hired Albert J. Di Marco in marketing, Reef C. Ivey for administration and as General Counsel, and Norman A. Sylvester for operations. These three, with McCulloch, eventually made the leveraged buyout. During the negotiations with McCulloch over his employment, Katz promised that if he decided to sell Nutri/System McCulloch would have the right to make an offer.

In November, 1985 Katz offered to sell Nutri/System to McCulloch's group for $70 million, which would yield approximately $7.00 a share for all shareholders. The stock was then selling at about $4.00 a share, no offers from outside the company were pending, and its business was still on a downtrend. Merrill Lynch Capital Markets was retained to provide financial advice and assistance in raising the cash which Katz desired. After performing a due diligence investigation Merrill Lynch proposed in January, 1986 that the transaction be financed by $40 million in senior notes financed by Merrill Lynch, $20 million in cash in the Nutri/System treasury, $10 million in subordinated debentures issued to the shareholders, and $5 million in equity funds invested by the McCulloch group. The purchasers and their wives were able to borrow $2 million on the security of their homes and other assets, but could not find venture capital for the $3 million shortfall. Merrill Lynch then restructured the transaction by increasing the senior

note underwriting to $45 million, with detachable warrants entitling the senior noteholders to acquire 35% of the new company within five years. Under the restructured transaction existing Nutri/System shareholders would receive $7.16 a share.

In January, 1986 the Company appointed Thomas Cameron and Dr. Martin Begun, the only two members of the board of directors not personally involved in the buyout, to investigate its fairness. Cameron and Begun retained Connecticut National Bank to prepare a fairness opinion on a negotiated fee for service basis. The agreement, according to the proxy statement, provided that Connecticut National Bank would receive $50 thousand for its opinion and an additional $25 thousand if it were published. To evaluate the fairness of the $7.16 a share price Connecticut National Bank made a discounted cash flow analysis in appraising Nutri/System's value. That analysis was based on cash flow projections made by the McCulloch group. Certain downward adjustments were made to the McCulloch group's projections to eliminate risks. Connecticut National Bank also assumed, for purposes of the discounted cash flow analysis, that Nutri/System's income would continue to be taxed for the next five years at the then-existing 46% corporate tax rate. In February of 1986 Connecticut National Bank issued a fairness opinion stating that the $7.16 a shareprice was fair to shareholders because the company was worth between $6.50 and $8.50 a share.

A proxy statement was filed with the Securities Exchange Commission in April of 1986. After several revisions, it was mailed to Nutri/System's shareholders on July 11, 1986, for a vote at a shareholders meeting on August 6, 1986.

The shareholders' suit was filed on August 1, 1986, seeking preliminary and permanent injunctive

relief against the leveraged buyout. A motion for a preliminary injunction against holding the shareholders meeting was denied. The shareholders voted overwhelmingly in favor of the proposed sale, and the leveraged buyout was closed on August 13, 1986.

Thereafter an amended complaint was filed and the case proceeded to trial before a jury. The district court during the trial precluded the shareholders from introducing any evidence relating to Nutri/System's performance following the buyout. Before submitting the case to the jury the district court partially granted defendants' Fed. R. Civ. P. 50(a) motion by removing certain issues raised by the shareholders from consideration by the jury. The case was submitted to the jury on special verdict interrogatories the answers to which favored the defendants. Judgment was entered in favor of the defendants, and these appeals followed.

II

While the shareholders claim numerous trial errors, we find only two which require a new trial.

A.

The directed verdict on use of a 48% tax rate assumption

The parties agree that the district court in effect granted defendants a directed verdict on the shareholders' contention that in selecting to project a 46% tax rate for 5 years Connecticut National Bank made an unreasonable choice. A more realistic choice, according to the shareholders, would have produced a significantly higher projected cash flow and thus a significantly higher valuation than $7.16 a share. Under Fed. R. Civ. P. 50(a) a "directed verdict may be granted only if, as a matter of law, viewing all the

evidence which has been tendered and should have been admitted in the light most favorable to the party opposing the motion, no jury could decide in that party's favor." *Indian Coffee Corp. v. Procter & Gamble Co.*, 752 F.2d 891, 894 (3d Cir.), *cert. denied*, 474 U.S. 863 (1985). There must be "sufficient evidence to submit to the jury for the purpose of resolving conflicts in the evidence or inferences permissibly drawn from the evidence, or both," *Edward J. Sweeney & Sons, Inc. v. Texaco, Inc.*, 637 F.2d 105, 116 (3d Cir. 1980), *cert. denied*, 451 U.S. 911 (1981). This court exercises plenary review of the grant of a directed verdict. *Indian Coffee Corp.*, 752 F.2d at 894; *Finkle v. Gulf & Western Mfg. Co.*, 744 F.2d 1015, 1021 (3d Cir. 1984).

An opinion or projection, like any other representation, will be deemed untrue for purposes of the federal securities laws if it is issued without reasonable genuine belief or if it has no basis. *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985). *Accord, Gottreich v.San Francisco Investment Corp.*, 552 F.2d 866, 867 (9th cir. 1977) (treating as actionable an opinion without adequate or reasonable basis); *S.E.C. v. Okin*, 137 F.2d 862, 864 (2d Cir. 1943) (treating as actionable an opinion for which there was "no ground"). *Cf. First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489-90 (9th Cir. 1974) (treating opinions as actionable where there was a gross disparity between them and the facts). The district court based its decision to remove the assumed tax rate issue from the jury on the fact that the proxy statement includes the following statement:

> Pending or Proposed Tax Legislation. The United States Congress is currently considering various

> tax reform proposals. Among the various proposals are provisions which, if enacted, would reduce ordinary income tax rates for both individuals and corporations, increase tax rates on capital gains, and strengthen the minimum tax and alternative minimum tax. If any such legislation is enacted, whether such changes would affect particular items of income or loss discussed below could depend on the effective dates chosen by Congress.

Thus the district court based its ruling not on the reasonableness of Connecticut National Bank's projections in its fairness opinion, but on the disclosure in the proxy statement that the tax law might change. Concentrating on the notice of possible tax reform, the district court failed to address the separate issue of possible fraudulence in the fairness opinion itself. The fairness opinion had independent significance to shareholders, for it was obtained by the disinterested directors for the purpose of determining whether the offer from management was fair. It was, moreover, an opinion of an expert on valuation. Indeed, Connecticut National Bank impliedly recognizes that the district court's basis for removing the question from the jury is irrelevant, when it argues that "to overturn the trial court's directed verdict, plaintiffs must demonstrate that there was more than a scintilla of evidence that CNB either did not genuinely believe in the propriety of its use of a 46% tax rate in calculating the fairness of the $7.16 price per share offered by Nutri/System's management or that CNB had no sound factual or historical basis for the use of the 46% rate." Cross Appellant's brief p. 36. Thus, we must examine the evidence presented by the stockholders on the reasonableness in July of 1986 of a projected cash flow valuation using the 46% tax rate assumption.

The shareholders' expert witness, John B. Torkelson, testified that it was inappropriate, in presenting a fairness opinion in July of 1986, to project a 46% effective tax rate over five years because "it was generally recognized by knowledgeable people in the field of financial analysis by July 1986 that the tax reform legislation pending before Congress was virtually certain to become law; that corporate income tax rates would be reduced to between 33 and 36 percent; and, that if CNB had used a tax rate in the 33 to 36 range in its discounted cash flow analysis, . . . the range of values for the company would be from $7.58 to $10.35 per share," rather than a range which included $7.16. J.A. at 699, 2073. Torkelson pointed out that by the summer of 1986 "articles throughout the financial press were all saying the same thing, which is that the House bill is one rate, the Senate bill is another rate, they are extremely close, they are going to compromise and the bill will take effect on July of 1987," J.A. 739-740. Employees of the Connecticut National Bank who worked on the fairness opinion testified that they were aware of the impending tax reforms. J.A. at 891, 997, 1027. Nutri/System management in preparing its budget took into account the fact that tax rates would change effective July 1, 1987. Exhibit No. 29, J.A. 1912.

There was conflicting evidence as well. An employee of Connecticut National Bank, Cathy Ann Tagan, noted the confusion and uncertainty surrounding the expected effects of tax reform, J.A. 996-97, and the fact that Nutri®Systems had paid in excess of a 46% rate over the prior five years when state and local taxes and amortization were included, J.A. 222. There was, moreover, evidence that Nutri®System paid total taxes amounting to 45% in the first year under the new tax law. J.A. at 743. The defendants urge that despite the evidence presented by the

stockholders the conflicting evidence establishes as a matter of law that the fairness opinion is not actionable.

The opposing parties disagree over the meaning of the *Eisenberg v. Gagnon* test for the actionability of misrepresentations in an opinion or projection. The defendants contend that the shareholders cannot prevail unless they establish that there was no historical basis in fact for the 46% rate. If there is (and obviously there is), then Connecticut National Bank's decision to project that rate rather than others which might have been chosen for projection is unactionable as a matter of law. The shareholders, on the other hand, define the *Eisenberg v. Gagnon* issue as whether the *selection* of the 46% rate among others that could have been selected was reasonable in light of all the evidence, including expert opinion evidence that financial experts were at the time relying on a much lower projected tax rate.

In *Eisenberg v. Gagnon* we held that projections are actionable if "issued without a genuine belief or reasonable basis," 766 F.2d at 776, thus articulating both a subjective ("without genuine belief") and an objective (without "reasonable basis") test. Given that the test is intended to identify deviations from the appropriate standard of care in expressions of opinions by professionals "with greater access to information or having a special relationship to investors making use of the information," *Eisenberg*, 706 F.2d at 776, the more reasonable interpretation of the rule is that it permits recovery when an expert, in making a projection, adopts an assumption which the factfinder concludes was objectively unreasonable in the circumstances.

Applying the *Eisenberg* test to the evidence referred to above, we hold that it is sufficient to present a jury question as to whether it was reasonable for

Connecticut National Bank to render a fairness opinion in July of 1986 based on a cash flow projection which assumed a 46% tax rate for the next five years. The Court erred, therefore, in directing a verdict on this issue.

B.

The instruction on the pendent state law claim.

The shareholders' pendent state law claim for breach of fiduciary duty asserts that if the jury found the consideration for the leveraged buyout to be in fact unfair, Pennsylvania law would permit recovery from the fiduciaries for their unfair self dealing. The Court refused to instruct the jury to that effect, and the shareholders' objection to the instruction in this respect was preserved. J.A. at 1479. The defendants make two responses to this contention.

The first response is that the state law claims are not independent of the federal law claims which were decided in their favor because the shareholders allege no additional claims of bad faith beyond those litigated in the federal securities claims. We reject this response. The gravamen of the federal claims, for liability purposes, is inadequate disclosure. The gravamen of the state law claim pressed by the stockholders is unfair consideration resulting from self dealing by fiduciaries. Clearly the jury did not reach and decide the question of fairness of the consideration in disposing of the federal non-disclosure issues. The defendants' second response is more troublesome, namely, that section 515K of the Pennsylvania Business Corporation Law excludes any post-merger remedy other than an appraisal proceeding, including even a federal private right of action. Thus, defendants urge, even the section 10(b) and 14(a) federal claims

should not have gone to the jury. The statute on which this response is predicated provides:

> Any shareholder, who desires to object to, or dissent from, any proposed plan authorized under any section of this act, and where this act provides the shareholders so objecting or dissenting shall have the rights and remedies herein provided, shall be limited to the rights and remedies prescribed under this section, and the rights and remedies prescribed by this section shall be exclusive.

15 P.S. § 1515K (Purdon 1967). The rights and remedies referred to in section 515K are the rights of dissenting shareholders to demand an appraisal of the fair value of their stock and to have it purchased by the corporation. The defendants interpret section 515K to exclude all post-merger remedies, including remedies for misrepresentation and for breach of fiduciary duty.

We note that this action was commenced at the pre-merger stage, and that preliminary injunctive relief was denied on the ground that an adequate damage remedy could be fashioned for the shareholders. Another provision of the Pennsylvania Business Corporation Law provides that "a shareholder shall not have any right to obtain, *in the absence of fraud or fundamental unfairness*, an injunction against any proposed plan. . . or to claim the right to valuation of and payment of his shares. . . except that he may dissent and claim payment if and to the extent provided in section 515 of this act. . . ." 5 P.S. § 1005E (emphasis added). The Supreme Court of Pennsylvania construed this 1968 Amendment to the Business Corporation Act as a preservation, despite the exclusivity language in section 515K, of the common law right of shareholders to enjoin proposed unfair or fraudulent corporate actions. *In re Jones & Laughlin*

Steel Corp., 488 Pa. 524, 412 A.2d 1099, 1103-04 (1980) (citing *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1955) and *Weisbecker v. Hosiery Patents, Inc.*, 356 Pa. 244, 51 A.2d 811 (1947)). Thus the question presented is whether given the availability in Pennsylvania of suits to enjoin breaches of fiduciary duty, the Pennsylvania Supreme Court would construe section 515K as prohibiting the other forms of relief such as rescission or money damages. To state the issue in terms with which corporate practitioners will be familiar: would the Supreme Court of Pennsylvania follow *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983), the leading Delaware case on breach of fiduciary duty in a cash out merger?

The defendants rely chiefly upon the Superior Court opinion *In re Jones & Laughlin Steel Corp.*, 263 Pa. Super. 378, 398 A.2d 186 (Pa. Super. 1979), which contains language possibly suggesting that the section 515K appraisal right is exclusive of any other shareholder remedy. The holding of that case, however, is only that an appraisal court lacks jurisdiction to consider the fairness of the underlying merger. Indeed the case was before the Superior Court at an interlocutory stage pursuant to 12 P.S. § 672 (Purdon 1967), which affords an appeal from an order involving questions of jurisdiction. That jurisdictional holding was affirmed by the Supreme Court in *re Jones & Laughlin Steel Corp.*, 488 Pa. 524, 412 A.2d 1099 (1980), but as we note above the Supreme Court took pains to point out that 15 P.S. § 1005E preserved shareholder remedies other than statutory appraisal. Moreover, although the *Jones & Laughlin* opinion on which the defendants rely was a section 515 post-merger appraisal suit, the underlying merger spawned, as here, a pre-merger shareholder class action seeking injunctive relief and/or damages. *Tanzer Economic Associates, Inc. v. Haynie*, 388 F.

Supp. 365 (S.D.N.Y. 1974) (refusing to grant requested injunction), 405 F. Supp. 650 (S.D.N.Y. 1976) (refusing to dismiss complaint seeking damages). The Supreme Court of Pennsylvania noted the pendency of the *Tanzer* litigation, 412 A.2d at 1101, and by noting the propriety of a pre-merger lawsuit, preserved in 15 P.S. § 1005E, tacitly approved it. Eventually the *Tanzer* suit was settled, the settlement involved payment of damages, and in a subsequent stage of the *Jones & Laughlin* appraisal litigation the Superior Court made reference to it as follows:

> The *Tanzer* litigation is to be contrasted to the appraisal claim under the Business Corporation Law - Rights of Dissenting Shareholders, where the only relief available is a "judgment against the corporation for the amount of the fair value of their shares . . . ." 15 P.S. § 1515(F). This limitation has been recognized by our Supreme Court in the present case upon prior appeal where it was determined that the appraisal remedy was the exclusive right which could be pursued in the present action. The court further recognized that dissenters could seek relief for unfair or fraudulent corporate actions in separate actions. See *In re Jones & Laughlin Steel Corp., supra*, 412 A.2d at 1103-04. Thus, our highest court has recognized in this very case that separate and distinct causes of action may be pursued as a result of the same purchase offer.

In re Jones & Laughlin Steel Corp., 328 Pa. Super. 442, 453, 477 A.2d 527, 532 (Pa. Super. 1984). The unqualified statement about pursuing separate causes of action was made in the course of rejecting *Jones & Laughlin*'s contention that by failing to opt out of the *Tanzer* class the appraisal plaintiffs were barred by *res judicata*. Thus it is a clear holding that in

Pennsylvania the statutory appraisal cause of action coexists with common law causes of action. Indeed no other rule makes sense, for the appraisal remedy is available even absent misconduct of corporate officials. It was hardly enacted to provide a shield for such misconduct. We predict, therefore, that if faced with the issue the Pennsylvania Supreme Court would reject the defendants' interpretation of section 515K as a bar to other causes of action for breach of fiduciary duty or misrepresentation in a cash out merger.

Since the claim for breach of fiduciary duty by setting an unfair merger price was both separate from the federal nondisclosure claims and permitted under Pennsylvania law, the trial court erred in refusing to instruct the jury on that claim.

III

Other errors claimed by the shareholders would not in our view require a new trial but are addressed here since the issues may reoccur.

A.

The directed verdict on the pricing issue

The shareholders contend that the proxy statement misrepresented the negotiations leading to the leveraged buyout by suggesting that the price was arrived at through arms length negotiations, when in fact the terms and timing of the sales were dictated by Katz. The district court refused to submit to the jury the question of materiality of this alleged misrepresentation. J.A. 1211. Thus we must consider whether there was any evidence from which a jury could infer a material misrepresentation about the negotiations. The challenged language in the proxy statement reads:

> During the summer and fall of 1985 Mr. McCulloch indicated to Mr. Katz that he and other members of senior management were interested in structuring a leveraged buyout of Nutri/System. Preliminary efforts to determine the availability of financing were also initiated. In November and December 1985 further discussions took place among Mr. McCulloch and other members of the Investor Group and their advisors and Mr. Katz and his advisors.

Proxy Statement p. 23, J.A. at 1523. The shareholders claim that the jury would, or at least could, read this passage to imply that an arms length negotiation took place, when in fact Katz made a take it or leave it proposal.

There are two difficulties with the shareholders' contention. First, the quoted passage does not refer to negotiations, arms length or otherwise, but to discussions; a generic term which no more suggests arms length negotiations than it suggests self dealing. Second it is hard to imagine how a representation that arms length negotiations took place between Katz and McCulloch would be material, in the required legal sense of importance to a reasonable shareholder in making a decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The principal ingredient in such a decision is fairness of the proposed price, and the relationship between the history of the negotiations and the fairness of the price is on this record simply too attenuated. Thus the district court properly refused to submit the "negotiations" issue to the jury. With other evidence of record than that which we review the question might appear differently.

B.

Exclusion of Evidence of
Post-Merger Performance

The shareholders sought to introduce evidence that Nutri/System's performance substantially exceeded the projections disclosed in the proxy statement during the first year after the leveraged buyout. Anticipating this evidence the defendants made a motion *in limine* to exclude it. The district court denied the motion without prejudice to its reconsideration, admitted it, but at the close of the testimony instructed the jury to disregard it. The shareholders contend that this ruling was error.

The shareholders do not contend that evidence of post-merger performance is relevant to the fairness of the Connecticut National Bank fairness opinion. They urge, however, that it is relevant (1) for the purpose of proving management's pre-merger intentions, and (2) for the purpose of proving the value of the shares at the time of the buyout. Since the district court effectively withdrew the common law breach of fiduciary duty claim from the jury, the second possible ground of relevance apparently was not considered. The court's discussion appears to focus on use of the post-merger performance as evidence of managements pre-merger intentions or expectations. While the evidence may have met the rather low threshold of relevance under Fed. Evid. R. 402, *see Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 93 (E.D.N.Y. 1969), *modified on other grounds*, 478 F.2d 1281 (2d Cir. 1973), the court did not abuse its discretion in excluding it under Fed. Evid. R. 403 on the ground that the possible prejudice arising from use of events long after the preparation of the proxy statement to cast light on the defendants' earlier intention outweighed its limited probative value. *See, e.g., Rovegno v. Geppert Bros., Inc.*, 677

F.2d 327, 329 (3d Cir. 1982); *United States v. Allessandrello*, 637 F.2d 131, 146 (3d Cir. 1980), *cert. denied*, 451 U.S. 949 (1981); *United States v. Long*, 574 F.2d 761, 767 (3d Cir.), *cert. denied*, 439 U.S. 985 (1978). Whether, on trial of the common law breach of fiduciary duty claim the evidence may be used to establish pre-merger value of Nutri/System is a different question. There is merit to the defendants' objection that post-merger performance is not a recognized method of proving value, at least absent evidence of obstacles to the use of other accepted method of value such as market price, net asset value, and investment value. No such evidence appears in the present record.

C.

The Wording of the Special Verdict Interrogatories

The shareholders contend that the district court committed prejudicial error in formulating special verdict interrogatories Nos. 1, 2, 3 and 4. Under Fed. R. Civ. P. 49(a) they are deemed to have waived any objection to the interrogatories unless those objections are made known to the court before the jury retires. The record discloses no such objection to Interrogatories No. 1, 2, 3 and 4. Thus we can consider the objections now only if they rise to the level of plain error. Moreover use and form of interrogatories is a matter for discretion of the district court. *McNally v. Nationwide Insurance Co.*, 815 F.2d 254, 266 (3d Cir. 1987).

The shareholders' first objection is to Interrogatory No. 1 which asks:

> Did the proxy statement contain a misrepresentation of material fact because it included

> the fairness opinion of Connecticut National Bank?

The shareholders contend that this question is misleading in that it might confuse the jury on the standard of fraudulence of an opinion rather than of a fact. Their own proposed question, however, is no clearer in elucidating the fact-opinion distinction. We find no plain error.

The second interrogatory asks:

> Did the proxy statement contain an omission of material fact because it did not include the projections developed by A. Donald McCulloch, Jr. that included his prediction that there was a 55 percent change of exceeding published figures by 20 percent?

The shareholders claim that this question assumes that the projection referred to is attributable only to McCulloch, not to the entire management group. We do not see any such defect. The evidence suggests that McCulloch made the projection. The jury was free, answering the question as worded, to decide whether the management should have disclosed it. That appears to have been the understanding of counsel for the shareholders at trial. J.A. at 1195-96. We find no plain error.

The third and fourth interrogatories ask:

> 3. Does Exhibit P-24 accurately state a part of the contract between Connecticut National Bank and Nutri/System, Inc. concerning compensation to the bank for its services in rendering its fairness opinion?
>
> 4. Did the proxy statement contain an omission of material fact because it did not state the terms of the contract between Connecticut National Bank and Nutri/System, Inc. set forth in Exhibit P-24?

The shareholders claim that somehow these questions removed from the jury's consideration two questions: what was the real fee arrangement; and was it adequately disclosed. In light of the fact that Exhibit P-24 states that $25,000 will be returned if the leveraged buyout does not close we are at a loss to see any defect, let alone plain error.

D.

Jury Instructions

With the exception of the instruction on the pendent state law claim, which was preserved, the defendants failed to preserve objections to the district court's jury instructions. Fed. R. Civ. P. 51(a). None of the objections pressed on appeal can be so regarded.

IV.

In its protective cross appeal Connecticut National Bank contends that the trial court erred in instructing the jury on the standard of liability applicable under section 14(a) to an outside professional such as an investment banker rendering an opinion in connection with a merger. Since we are remanding for a new trial, it is appropriate to address that contention. *Rhoads v. Ford Motor Co.*, 514 F.2d 931, 934 (3d Cir. 1975). The bank's specific objection is to the court's instruction that "the intent to deceive or cheat" was not necessary to establish its liability. J.A. at 1458. The bank specifically requested a *scienter* charge.

Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976), which rejected the *scienter* requirement in cases under section 14(a), did not specifically address the liability of a bank that produces a fairness opinion. *Gould* did, however, on policy grounds, distinguish section 14(a) cases from those arising under section 10(b), under which a *scienter*

charge is required, *see Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *Gould*, *supra*, 535 F.2d at 777-78. The *Gould* court analogized proxy statements to registration statements, both of which require careful disclosures to persons who are expected to act in reliance on the accuracy of those disclosures. *Id.* The test under section 14(a) is materiality of the disclosure. *TSC Inc. v. Northway, Inc.*, 425 U.S. 438 (1976). A material misrepresentation even when made negligently rather than intentionally or recklessly, can still inflict the anticipated harm, and is thus deemed actionable.

In asking us to depart from the *Gould* standard for outside advisers such as accountants and investment bankers, Connecticut National Bank relies on *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.) *cert. denied*, 449 U.S. 1067 (1980), which applied a *scienter* standard for an accountant who prepared a financial statement attached to a proxy statement. The reasoning of *Adams*, however, appears to be inconsistent with that of *Gould*, for it suggests that the *scienter* standard would apply in a section 14(a) case even for officers and directors. This panel is bound by *Gould*, which rejects the application of a *scienter* standard to such persons. Moreover since an investment banker rendering a fairness opinion in connection with a leveraged buyout knows full well that it will be used to solicit shareholder approval, and is well paid for the service it performs, we see no convincing reason for not holding it to the same standard of liability as the management it is assisting.

V.

The judgment appealed from will be reversed, and the case remanded for a new trial.

HUNTER, *Circuit Judge*: dissenting:

1. My colleagues would remand this case to determine whether defendant Connecticut National Bank (CNB) had a reasonable basis for selecting a 46% tax rate in calculating a five-year cash flow projection for Nutri/Systems. The parties do not dispute that use of the 46% rate was accurate under the tax laws as they existed at the time CNB gave its opinion. Thus, in rendering its fairness opinion, the bank did no more than rely on the law as it existed. Because I believe that CNB reasonably may rely on the law, I respectfully dissent.

2. The question before us is not whether the 46% rate was the only one that CNB reasonably could have chosen, but whether there was a reasonable basis for its choice. *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985). The majority holds that CNB may have acted unreasonably in relying on the existing tax rate because Congress was then working on major tax reform legislation which would lower the top marginal income tax rate for corporations. CNB had a more than ample basis for choosing the existing rate. The tax rate on which CNB relied was the law; there was no other law due to take effect. At the time of the fairness opinion, the tax reform law still was being considered by a joint committee of the House and Senate. It had been passed by neither body, nor signed by the President. This fact alone provides a sufficient reasonable basis for CNB's choice of tax rate.

3. Even had the lower rate been ready to take effect, CNB's choice of rate would be reasonable. Tax reform was predicted to extend far beyond tax rates. As the majority notes, there was substantial uncertainty about what the "bottom line" effect of all the changes would be. I cannot agree with the majority, however,

that the securities laws required CNB to speculate on all the intricacies and effects of major legislation. Further, the cash flow projections extended over five years. Given the rising federal deficit and the several impending elections, CNB could not be certain that any lowered rate would not be increased within that five-year span. In the face of this uncertainty, the tax reform was being widely-publicized as "revenue neutral." This combination of factors provides CNB a reasonable basis to conclude that the existing 46% rate would not be far off the "bottom line" under the new laws.

4. I cannot agree that, by applying the law as written in making its projections, CNB acted without a reasonable basis for its opinion. I therefore dissent.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

Order of the United States Court of Appeals for the Third Circuit Denying CNB's Petition for Rehearing

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 87-1786-91
87-1798-1803

HENRY HERSKOWITZ, et al.

Appellants

v.

NUTRI/SYSTEM, INC., et al.

SUR PETITION FOR REHEARING

Present: GIBBONS, *Chief Judge,* SEITZ, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, and HUNTER,* *Circuit Judges.*

The petition for rehearing filed by appellant, Connecticut National Bank, in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS
Chief Judge

Dated: Oct. 11, 1988

*As to panel rehearing only.

Order of the United States Court of Appeals for the Third Circuit Denying Nutri/System, Inc., *et al.'s* Petition for Rehearing

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The petition for rehearing filed by appellees in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS

Chief Judge

Dated: Oct. 11, 1988

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*As to panel rehearing only.

Judgment of the United States District Court for the Eastern District of Pennsylvania

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

HENRY HERSKOWITZ, et al.	:	CIVIL ACTION
	:	
vs.	:	No. 86-711, 86-712,
	:	86-725, 86-800,
NUTRI/SYSTEM, INC., et al.	:	86-828 and 86-877

CIVIL JUDGMENT

Before Hon. Louis C. Bechtle

AND NOW, this 16th day of November 1987, in accordance with Interrogatories submitted to the jury and answers thereto,

IT IS ORDERED that Judgment be and the same is hereby entered in favor of the defendants, Nutri/System, Inc., et al. and against the plaintiffs, Henry Herskowitz, et al.

BY THE COURT:

ATTEST: MARION C. SCARANGELLI
Deputy Clerk

ENTERED: NOV. 17 1987
CLERK OF COURT
Civ 1 (8/80)

Text of Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9.

§78n. Proxies

Solicitation of proxies in violation of rules and regulations

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

§240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement

contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or association, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

(Secs. 19(a), 3(b), 23(a)(1), 20, 319(a), 48 Stat. 85, 882, 901; sec. 209, 48 Stat. 908; 49 Stat. 833; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; 53 Stat. 1173; secs. 3, 18, 89 Stat. 97, 155; sec. 308(a)(2), 90 Stat. 57; 15 U.S.C. 77s(a), 78c(b), 78w(a)(1), 79t, 77sss(a))

[31 FR 212, Jan. 7, 1966, as amended at 41 FR 19933, May 14, 1976; 44 FR 38815, July 2, 1979; 44 FR 68456, Nov. 29, 1979]

Fairness Opinion of Connecticut National Bank

Connecticut National Bank
1604 Walnut Street
Philadelphia, Pennsylvania 19103
215/985-1243

July 11, 1986

DEAN MARTIN BEGUN, DIRECTOR
and
MR. THOMAS W.L. CAMERON, DIRECTOR
Nutri/System, Inc.
3901 Commerce Avenue
Willow Grove, Pennsylvania 19090

Gentlemen:

The Investment Banking group of The Connecticut National Bank ("CNB") has been retained by the Special Committee (Dr. Begun and Mr. Cameron) of the Board of Directors of Nutri/System, Inc. ("Nutri/System" or "the Company") to render an opinion as to the fairness, from a financial point of view, of the consideration to be received by the Company's shareholders pursuant to a merger of the Company with a newly formed privately held company.

Consideration per share to be paid to the shareholders of Nutri/System for their common stock consists of $6.13 cash, together with Subordinated Discount Debentures due 2001 issued by the Company. The face amount of the Subordinated Discount Debenture per share exchanged will be $1.03 plus an amount equal to interest on $1.03 compounded semi-annually for five years at a rate of the greater of 12.5% or 100 basis points over the yield to maturity to original holders of the Senior Notes due 1996 to be issued contemporaneously with the issuance of the Debentures. No cash interest payments will be made on the Subordinated Discount Debentures for the first five years although original

issue discount will accrete during such period. Interest will be payable currently at the same rate commencing five years after the merger. The Subordinated Discount Debentures also will contain semi-annual sinking fund provisions sufficient to retire 20% of the original principal amount per annum, commencing in year eleven.

The Connecticut National Bank, as part of its investment banking business, is regularly engaged in the valuation of securities and companies in various types of securities transactions, including the valuation of securities and companies in mergers and leveraged buyouts and in the determination of adequate consideration in such transactions. As background for our analysis of the proposed transaction, we discussed the history, current operations and future prospects of Nutri/System with its management at its prior headquarters in Jenkintown, Pennsylvania. Our financial analysis is based upon, among other things, Nutri/System's audited financial statements, filings with the Securities and Exchange Commission, Annual Reports for the Company, interim financial statements and internal operating reports. Industry information and financial data on relevant transactions were obtained from regularly published industry and investment sources.

Subsequent to submission of our opinion to Nutri/System's Board of Directors, CNB was retained to perform a preliminary appraisal of certain of Nutri/System's tangible and intangible assets.

In accordance with the terms of the engagement letter dated January 20, 1986, we submit this letter which sets forth our opinion and summarizes the procedures used in arriving at that opinion.

A. Documents and Information Examined

The following were among the documents and information we examined during the course of our analysis:

1. Nutri/System Annual Reports to shareholders for the fiscal years ended July 31, 1981-1985.

2. Nutri/System Quarterly Reports for the periods ending October 31, 1984, January 31, 1985, April 30, 1985, October 31, 1985, January 31, 1986 and April 30, 1986.

3. Filings with the Securities and Exchange Commission by Nutri/System, Inc. on Form 10-K for the fiscal years ended July 31, 1981-1985 and on Forms 8-K dated September 8, 1984, February 4, 1986 and April 25, 1986.

4. Nutri/System Common Stock Prospectuses dated January 8, 1981, and January 12, 1983.

5. Nutri/System Proxy Statement and Notice of Annual Meeting of Shareholders dated October 31, 1985.

6. Management-prepared document entitled *Nutri/System, Inc.* including description of the Company, history and background, and 1986-1990 budgets.

7. Additional operating and other data regarding Nutri/System as provided by management including financial results for the Company's Fox-Morris Associates, Inc. subsidiary.

8. Daily price and volume activity for the common shares of Nutri/System as traded on the New York Stock Exchange from August 11, 1982 to July 9, 1986 and as traded over the counter from January 8, 1981 to August 10, 1982.

9. Data regarding the economy as a whole and conditions in the industries in which Nutri/System operates.

10. Amended and Restated Agreement and Plan of Merger dated as of February 4, 1986, by and

among Diversified Services Group, Inc., Management Acquisition Group, Inc. and Nutri/System, Inc.

11. Indicative term sheets for Units comprised of Senior Notes and Warrants, and Subordinated Discount Debentures.

12. Filing with the Securities and Exchange Commission by Nutri/System, Inc. on Form S-1 dated April 17, 1986; Amendment No. 1 thereto dated June 27, 1986; Amendment No. 2 thereto dated July 8, 1986; and Amendment No. 3 thereto dated July 10, 1986.

13. Filing with the Securities and Exchange Commission by Nutri/System, Inc. on Form S-4 dated April 17, 1986; Amendment No. 1 thereto dated June 27, 1986; Amendment No. 2 thereto dated July 8, 1986; and Amendment No. 3 thereto dated July 10, 1986.

B. Persons Interviewed

During the course of our investigation, we conducted meetings and interviews with persons who, in our judgment, were capable of providing us with information necessary to complete the assignment. These meetings and interviews included, but were not limited to, senior executives of Nutri/System, Nutri/System's major shareholder, certain members of Nutri/System's Board of Directors, Nutri/System's legal counsel and the underwriter of the Senior Notes.

C. Facilities Visited

As part of the development of information and our opinion, we visited the following facilities:

1. Nutri/System's corporate headquarters.

2. Nutri/System's warehouse facility in Trevose, Pennsylvania.

3. A franchise-operated weight-loss center located in King of Prussia, Pennsylvania.

D. Factors Considered

In arriving at our opinion, we considered the following factors, among others, which we deemed relevant:

1. The terms and conditions of the proposed offer.

2. The nature of the businesses in which Nutri/System operates and the future prospects for each.

3. The history and management of the Company.

4. The historical and current operating results and the factors affecting these results.

5. The historical and current financial condition of Nutri/System.

6. The historical and current book value for the Company's assets and liabilities.

7. Volume and price activity on the New York Stock Exchange and over the counter for the common shares of Nutri/System, Inc.

8. Conditions in the general economy and the future prospects for Nutri/System and the industries in which it operates.

9. Pro forma financial projections and balance sheets for Nutri/System as prepared by management.

10. Nutri/System's ability to service the subordinated debt which will be offered to the shareholders as part of the consideration paid in the purchase of their shares of the Company's Common Stock.

E. Access to Information and Personnel

During our investigation, we received access to all materials and personnel which we deemed necessary and adequate for the purposes of formulating the opinion expressed in this letter.

F. Assumptions and Limitations

Our opinion is subject to the following assumptions and limitations, among others:

1. We express no opinion as to:

a. The tax consequences of the transactions, if any.

b. The effect of the tax consequences, if any, on the holders of the Securities which are the subject of the transactions contemplated.

2. We have made no independent verification of the financial and operating data contained in Nutri/System's audited financial statements, filings with the Securities and Exchange Commission, Annual Reports or other data provided to us by the Company or of publicly available financial data obtained from accepted sources.

3. We assume that the transaction proposed by the Company's management to the present shareholders of Nutri/System is, in all respects, lawful under applicable corporate law and under guidelines adopted by various governing boards or agencies regarding the purchase of securities subject to margin rules.

G. Conclusion

In preparing our opinion, we have relied upon the completeness and accuracy of the information and data furnished to us by the Company. We have not independently verified such data. We are not aware of any present or contemplated relationship between The Connecticut National Bank and Nutri/System or the Company's majority shareholder that in CNB's opinion would affect CNB's ability to render a fair and independent opinion in this matter.

Based upon the foregoing analysis and review, other matters we considered relevant and upon our general knowledge and experience in the valuation of securities, it is our opinion that the consideration per share of $6.13 in cash, together with the Subordinated Discount Debentures as described previously herein, to be received by the Company's shareholders is fair from a financial point of view as of the date of this letter.

Respectfully submitted,

CLEMENT H. DARBY
Managing Director
Investment Banking